7-7-1997

A Brilliant Instance of Flabby Thinking

Deborah A. Geier
Cleveland State University, d.geier@csuohio.edu

Original Citation
Deborah A. Geier, A Brilliant Instance of Flabby Thinking, 76 Tax Notes 124 (July 7, 1997)

A Brilliant Instance of Flabby Thinking

by Deborah A. Geier

Deborah A. Geier is associate professor of law at Cleveland-Marshall College of Law, Cleveland State University.

At the recent ABA Tax Section meeting in Washington, D.C., I attended a meeting where a government representative informed the audience that one proposal on the potential list of needed revenue raisers for the upcoming budget bill would be repeal of the "lower-of-cost-or-market" rule of Treasury regulation section 1.471-2(c).[1] As previous attempts to repeal this rule have failed in the past, however, he did not venture a guess at its chances of enactment.

I had, in my naiveté, always assumed that the lower-of-cost-or-market rule was a bastion of sound financial reporting accounting that was simply imported into tax accounting in an early era when resort to financial accounting was common in the absence of well-developed tax thought. In the course of doing research for an article,[2] however, I found out that the rule was created by an Englishman in the early part of this century — and exported to America — chiefly as a means to reduce taxes! In his classic 1939 textbook,[3] Stephen Gilman wrote:

> As will be seen in subsequent chapters, inventory practices have long been affected by tax considerations. The illogical rule of cost or market, while not originating in this country, became popular here upon the advent of the Federal income tax program. Paton says that: "The early American enthusiasm for the device — among trade associations, business managements, and corporate accountants — was not a tribute to the merits of the scheme as a worthwhile accounting mechanism — but as an immediate method of reducing taxable income." He adds that the cost or market rule is not time-honored and that "it waxed on account of considerations far removed from the development of sound accounting."[4]

A rather lengthy excerpt from the relevant "subsequent chapter" merits full quotation, as I cannot improve upon it.

> In 1904 John A. Walbank, an English writer, in the *Encyclopedia of Accounting*, endorsed revaluation at cost or market. The same year at the St. Louis Worlds Fair in conjunction with which a Congress of Accountants was held under the auspices of the Federation of Societies of Public Accountants, Arthur Lowes Dickinson, an outstanding English-trained accounting authority, read a paper which was significant in many respects. Of special interest, however, was his statement that "the general rule for valuation of Stocks on hand, namely, 'cost or market, whichever is lower,' has been evolved and is adopted by the most conservative commercial institutions."
>
> The significance of this is threefold. First of all, Dickinson was an undoubted authority, second, he refers to the rule as a "general rule," and third, by inference, he justifies the rule by the doctrine of conservatism. A dissenting voice, however, was heard at this meeting: another English accountant John Hyde, suggested that "no great harm would be done if we would simply continue to put this in at the cost price." In general, however, the dissent was feeble.
>
> In 1906 Lisle, in his *Accounting in Theory and Practice*, endorsed the cost or market rule. In the same year William M. Lybrand announced that the rule "has everything to commend it from a conservative viewpoint" although he confessed that it was not entirely logical. . . .
>
> In 1910 a courageous attack on the cost or market rule was made by Greedlinger. . . .
>
> This bold statement by Leo Greedlinger seems to mark the beginning of a new school of account-

---

[1]*See* my memory (if you can plow through the cobwebs). For the uninitiated, inventory accounting computes gross income from the sale of inventory by subtracting the "cost of goods sold" from "gross sales receipts." "Cost of goods sold" is computed on a pool basis, not by tracking the cost basis of each individual piece of inventory actually sold. This is accomplished by starting with the cost of the opening inventory pool at the beginning of the year, adding inventory purchased or produced during the year, and subtracting closing inventory (the goods remaining on hand at the close of the year.) The number obtained represents the inventory disposed of during the year. Closing inventory becomes opening inventory for the next year. Notice that if the number used for closing inventory can be *lowered*, the cost of goods sold increases, which *decreases* gross income from the sale of inventory for tax purposes. Assume, for example, that opening inventory is $300, inventory purchased during the year is $200, and closing inventory is $400. The cost of goods sold would be $100 ($300 + $200 - $400). If gross sales proceeds are $300, then gross income derived from sales is $200 ($300 - $100). If the taxpayer can increase the cost of goods sold to $200 by decreasing closing inventory by $100, gross income is decreased to $100 ($300 - $200). Because closing inventory becomes opening inventory for the next year, this deferral of income can be perpetual. The lower-of-cost-or-market rule allows taxpayers with sufficient proof of market price, *see Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), to achieve this result by using a current lower market price for items in closing inventory rather than using their historic cost bases. And it's a one-way street. If current market prices are higher than historic cost basis, closing inventory is not similarly increased, thus increasing gross income. Such a deal!!

[2]"The Myth of the Matching Principle as a Tax Value" (forthcoming somewhere soon, I hope, if I can get the tome finished and get it accepted for publication).

[3]Stephen Gilman, *Accounting Concepts of Profit* (1939).

[4]*Id.* at 17 (footnotes omitted) (quoting W.A. Paton, "Comments on 'A Statement of Accounting Principles,'" *The J. of Accountancy* 202 (March 1938)).

ing thought which has become increasingly heard during the years following. Among its leaders were such thoughtful students as Harry C. Bentley, Roy B. Kester, and most insistent of all, W.A. Paton. During those years voices raised in favor of the cost or market rule were not quite so dogmatic as before. Lisle and Middleton in *Account-Keeping in Principle and Practice*, recommended the rule "so as to err on the safe side."

An editorial in *The Journal of Accountancy*, July 1921, while endorsing this method, admitted that it was "not strictly in accordance with the basic theory," a comment typical of many accountancy writings during the past two decades.

Practically, 1917 was a most important year in the history of the cost or market rule. This was the year of its recognition by the U.S. Treasury Department and by the British Board of Inland Revenue. . . .

In the United States, prior to 1917, the Bureau of Internal Revenue had recognized the cost basis.

Paton, in March 1938, reviewed the events of 1917, stating that originally the rule of cost or market "was not officially recognized as sound practice by the United States Treasury Department." He asserted that in 1917 this rule was "an immediate method of reducing taxable income (and some concerns paid heavily for making the shift just before a higher level of tax rates appeared)." In other words, the wide use of this rule in the United States is not as time-honored as many think, and it waxed on account of considerations far removed from the development of sound accounting.

In 1922 Paton took a strong stand against the cost or market rule, labelling it as thoroughly unreasonable. He reiterated this opinion in his book *Accounting* in 1924 . . .

Esquerre, in 1921, opposed the rule, saying, "There is, however, a good reason why market value should not be used at all."

In 1925 Greer, then with Ohio State University, told the American Association of University Instructors in Accounting that he would like to "hear someone get up and say, for example, that the valuation of inventories at 'cost or market, whichever is lower,' is not the proper method of valuation; that such a theory is nothing but a time-honored piece of hocum."

At the annual meeting of the American Institute of Accountants held in September 1927, at Del Monte, California, Hatfield . . . inferred that accountants were permitting their clients to influence accounting thought and labelled arguments in favor of the cost or market rule as "so brilliant an instance of flabby thinking as to deserve some further attention."[5]

A "brilliant instance of flabby thinking." Wish I'd written that. Need I say more? There is no tax defense for the rule. And its pedigree in financial accounting seems sufficiently tainted that any argument to maintain the rule out of deference for financial accounting theory seems to me now wholly deflated. If the rule remains intact, it would be a glowing testament to the sheer lobbying power of business interests in maintaining an ill-conceived and indefensible "loophole," nothing more.

---

[5] *Id.* at 440-44 (footnotes omitted).